

CHAPTER ONE

ACCOUNTING FOR MERCHANDISING INVENTORIES

Inventories

Inventories are;

- Asset items held for sale in the ordinary course of the businesses.
- Goods that will be used or consumed in the production of goods to be sold.

Classification of Inventories

Inventories are classified in to two Major areas

I. Inventories of merchandise businesses

- Are merchandise purchased for resale in normal operation of the businesses.

II. Inventories of manufacturing businesses

- Constitutes business that produces physical output.

Note that, the focus of this chapter will be the determination of the inventory of *merchandise business*.

Importance of inventories:

- Inventories are the most active elements in the operations of merchandise businesses.
- Inventories are the principal sources of revenue for the business.
- The cost of goods sold is the largest deduction from sales.
- Inventories are the largest current asset of the business.

1.2 Inventory Systems

The *two* principal inventory systems are periodic and perpetual inventory systems.

i. Periodic inventory system

- No continuous record of merchandise inventory account.
- The inventory balance remains the same through the accounting period.
- When goods are purchased they are debited to the purchase account rather than merchandise inventory account.
- The revenue from sale is recorded each time a sale made.
- No entry is made at the time of sale to record CGS (cost of goods sold).
- It is less costly to maintain than perpetual inventory system, but it provides management less information about the current status of merchandise.
- It is often used by retail businesses that sell many kinds of low unit cost of merchandise. E.g. drug stores, groceries etc.

ii. Perpetual inventory system

- The amount of inventory is continuously disclosed. So, the inventory balance will not remain the same in the accounting period.
- All increases are debited to merchandise inventory account and decreases are credited to the same account.
- At the time of sale, the CGS is reported in addition to journal entry for the sale. So, it is possible to determine EI and CGS.
- Under this system there is no need of physical counting at each accounting period.
- It is often used by companies that sell items of high unit cost. E.g. automobile companies.

1.3 Determining actual quantity in the inventory

In order to prepare financial statement, it is necessary to determine the number of units of inventory owned by the company at the statement date. For many companies, determining inventory quantities consists of two steps;

- a. Taking a physical inventory of goods on hand
- b. Determining the ownership of the goods

a. Taking a physical inventory

- It involves actual counting, weighting, or measuring each kind of inventory on hand.
- The physical count of inventory is needed in both periodic and perpetual inventory systems. Under periodic inventory system, it is needed to determine the cost of inventory and CGS.
- The inventory count under perpetual inventory system is always up to dated.
- Usually, there is an event where by the inventory account balance is different from the goods on hand. For instance, such events include theft, lose, damage, and errors. So, the physical count is used to adjust the inventory account balance to the actual quantity on hand.

b. Determining of ownership of Goods

- The ownership of goods should be considered before computing the cost of inventory, i.e., it needs to make sure that the company have not included in the inventory of any goods that do not belong to the company.

Goods in transit

- Goods are considered to be in transit when they are in the hand of a public carrier, such as a railways, trucking, or airlines company on the statement date.
- Goods in transit should be included in inventory of the party that has legal title to the goods. Legal title is determined by shipping terms (agreements)
- There are two main types of shipping points. FOB shipping point and FOB destination. FOB – meaning free on board

i) **FOB shipping point**

When the terms are FOB shipping point, ownership of the goods passes to the buyer when the public carrier accepts the goods from the seller. So, in this term of agreement the buyer takes all responsibility arising from the products liabilities.

ii) **FOB destination**

- Under this term the legal title to the goods remains with the seller until the goods reach the buyer.
- So, in general, goods on transit purchased on FOB shipping point terms are included in the inventory of the buyer and excluded from the inventory of the seller. And goods in transit purchased on FOB destination terms are included in the inventories of the seller and excluded from the inventory of the buyer.

Consigned Goods

- There is also a problem with goods on consignment at the time of taking an inventory. Goods on consignment to other part (agent) called the *consignee*. A consignee is to the goods for the owner usually on commission are included in the consignor's inventories and excluded from the consignee's inventories.

1.4 Inventory Costing Methods

There are *four* inventory costing methods, namely;

1. Specific Identification
2. First – in first – out (FIFO)
3. Last – in first – out (LIFO)
4. Weighted Average (WA)

Details of the above cost flow method will be shown in the following sections.

1.5 Inventory costing methods under a periodic inventory System

Costing of the inventory is complicated between the units on hand and for a specific item of inventory may have been purchased at different prices. For instance, in a period of rising prices, a company may experience several increases in the cost of identical goods within a given year. Alternatively, unit costs may decline. So, it is difficult to allocate the different unit cost of goods available for sale between EI and CGS. Inventory costing methods under a periodic inventory system can be viewed by using specific identification methods and cost flow assumptions (FIFO, LIFO, and, WA) methods that can be described in the following sections.

i) Using Specific Identification Method

This method tracks the actual physical flow of the goods. Each item of inventory is marked, tagged, or coded with its specific unit cost. It is possible when a company sell a limited variety of high unit cost items that can be clearly identified from the time of purchase through the time of sale.

e.g. automobile companies, music stores (pianos and organs)

When feasible, specific identification specific identification seems to be the ideal method of assigning CGAFS (cost of goods available for sale). Under this method, the EI is reported at the actual cost and the actual CGS is matched against sales revenue. This method, however, may enable management to manipulate net income.

ii) Using cost flow assumption

Because of specific identification is impractical, other cost flow methods are allowed. These differ from specific identification in the sense that they assume flows of costs that may be unrelated to the physical flow of goods. So, for this reason they termed as cost flow assumptions or methods that are namely as FIFO, LIFO, and WA methods.

To illustrate the above four inventory costing methods suppose that ABC Company uses a periodic inventory system and has the following information for the year of 2005.

<u>Date</u>	<u>Explanation</u>	<u>Units</u>	<u>Unit cost</u>	<u>Total costs</u>
Jan. 1	Beg. Inventory	80	60	4800
Feb., 10	Purchase	400	56	22,400
April, 5	Purchase	160	50	8,000
May, 20	Purchase	320	46	14,720
Dec., 15	Purchase	<u>240</u>	40	<u>9,600</u>
	Total	<u>1,200units</u>		<u>59,520</u>

The EI of the year consists of 300 units, 100 from each of the last three purchases.

a. Computation of EI under specific identification

Note that, the items on hand are specifically identified from which purchases they are:

Dec. 15 br. 100 x 40 = 4,000

May 20, br 100 x 46 = 4,600

April 5 br. 100 x 50 = 5,000

Total 300 units br 13,600

- Cost of ending inventory = Br. 13,600

- CGS = CMAFS – ending inventory (EI) = 59,520 - 13,600 = br. **45,920**

b. FIFO Method

The FIFO method assumes that the earliest goods purchased are the first to be sold. This means the cost flow is in the order in which the expenditure were made. So, to determine the cost of EI, we need to start from the most recent purchase and continue to the next recent. This method is generally good business practice in order to sell the oldest units first.

Computation of EI under FIFO Method

Dec., 15 ----- 240 @ 40 = br. 9,600

May 20, ----- 60 @ 46 = br 2,760

Total ----- 300 units **br 12,360**

- Cost of EI = br 12,360

- CGS = Cost of Merchandise available for sale (CMAFS) – EI
= 59,520 – 12,360 = **br 47,160**

c. LIFO Method

This method of assigning cost assumes that, the most recent purchases are sold first. Their costs are charged to CGS, and the costs of the earliest purchases are assigned to inventory. The cost flow is in the reverse order in which expenditures were made.

Computation of EI under LIFO Method

Jan.1 ----- 80 units @ 60 = br. 4,800

Feb.10 ----- 220 units @ 56 = br. 12,320

Total ----- 300 units br. 17,120

Cost of EI = br 17,120

CGS = br. 42,400

d. Weighted Average (WA) method

This method supposed that, the merchandises available for sale are homogeneous. This method of assigning cost requires computing the AC per unit of merchandise available for sale.

Computation of EI under WA Method

To determine the cost of EI, first the cost per unit of merchandise available for sale (MAFS) should be computed as follows.

AC per unit = CMAFS ÷ Total units available for sale

Next, the weighted average unit cost is multiplied with goods on hand at the end of the period to determine cost of EI. So, it is possible to calculate cost of ending inventory (CEI) by using the previous illustration

AC = 59,520 ÷ 1,200 = br 49.60

▪ Cost of EI = AC x good on hand
= br 49.60 x 300 = br. 14,880

▪ CGS = CMAFS – EI
= br 59,520 – br 14,880
= **br 44,640**

1.5 Inventory costing methods under perpetual inventory System

- Under perpetual inventory system each of the inventory cost flow method described in the above section for periodic inventory system can be applied. Under this system, at the time of each sale inventory on hand and CGS can be determined. That is, the merchandise inventory account is continually updated to reflect purchase and sales.

Illustration: To show the application of the three cost flow method the beginning inventory, purchases and sales of ABC Company for the month Jan. can be used.

	Unit	Cost
Jan. 1 Beg inventory -----	10	br. 20
5 Sale -----	7	
12 Pur. -----	8	br. 21
15 Sale -----	4	
20 Sale -----	2	
31 Pur.-----	10	br. 22

Perpetual – FIFO method

Computations:

Date	Purchase			Cost of goods sold			Inventory		
	Q	UC	TC	Q	UC	TC	Q	UC	TC
1							10	20	200
5				7	20	140	3	20	60
12	8	21	168				3	20	60
							8	21	168
15				3	20	60	7	21	147
				1	21	21			
20				2	21	42	5	21	105
31	10	22	220				5	21	105
				10	22	220	10	22	220
				13		Br. 263	15		Br 325

Cost Goods Sold = br. 263 (140 +60 +21 +42)

Cost Ending Inventory = br. 325 (105 + 220)

Goods available for sale = 28 (10 + 8 + 10)

Cost of merchandise available for sale = Cost Goods Sold + Cost Ending Inventory
= 588 (263 + 325)

Perpetual – LIFO method

Computations:

Date	Purchase			Cost of goods sold			Inventory		
	Q	UC	TC	Q	UC	TC	Q	UC	TC
1							10	20	200
5				7	20	140	3	20	60
12	8	21	168				3	20	60
							8	21	168
15				4	21	84	3	20	60
							4	21	84
20				2	21	42	3	20	60
							2	21	42
31	10	22	220				3	20	60
							2	21	42
							10	22	220
				13		Br 266	15		Br 322

Cost Goods Sold = br 266 (140 + 84 +42)

Cost Ending Inventory = br 322 (60 +42 + 220)

Cost of merchandise available for sale = Cost Goods Sold + Cost Ending Inventory
= 588 (266 + 322)

1.6 Estimating Inventory cost

Under cases where taking a physical inventory or maintaining a perpetual inventory become impossible for example, taking a physical inventory each month may be too costly, when a fire has destroyed the inventory (Catastrophe), estimation of inventory can be made. Two commonly used methods of estimating inventory costs are:

- 1) Retail method and
- 2) The gross profit method.

1. Retail Method of Estimating Inventory Costing

The retail inventory method of inventory costing is widely used by retail businesses, particularly department stores. Steps to be followed:

1. Find goods available for sale at cost and at retail price.
2. Calculate ratio of cost to retail price.

3. Find ending inventory at retail price.
4. Multiply ending inventory at retail by the ratio of retail price.

Example: Assume the following is hypothetical data taken from Dinsho merchandising business in the month of January 2019.

	<u>Cost</u>	<u>Retail</u>
Beginning inventory, Jan.1	Br.25,650	Br.35,000
Net purchase for the month	210,600	340,000
Net Sales		280,000

Solution

	<u>Cost</u>	<u>Retail</u>
Beginning inventory, Jan.1	Br.25,650	Br.35,000
Net purchase for the month	210,600	340,000
Net Sales		280,000

$$1. \text{ Merchandise available for sale} = 25,650 + 210,600 \qquad 35,000 + 340,000$$

$$\qquad \qquad \qquad = \underline{\text{Br. 236,250}} \qquad \qquad \qquad = \underline{\text{Br. 375,000}}$$

$$2. \text{ Ratio of cost to retail price:}$$

$$\qquad \qquad \qquad \frac{236,250}{375,000} = 63\%$$

$$3. \text{ Merchandising inventory, Jan31, at retail} \text{-----} 375,000 - 280,000 = \underline{\text{Br. 95,000}}$$

$$4. \text{ Merchandising inventory, Jan31 at estimated cost (Br.95,000*63\%)-} \underline{\underline{\text{Br59,850}}}$$

Advantage of Retail method:

- ❖ When only the selling price is available it permits valuation of inventory.
- ❖ Used to estimate the cost of inventory for interim accounting periods.
- ❖ Avoid the time- consuming and expensive process of taking a physical inventory each month or quarter.

2. Gross profit Method of Estimating costs of Inventories

Most companies would like to prepare interim financial statements such as monthly, quarterly or semiannually. Physical count inventory is made at the end of year. For this reason the companies use some methods to calculate its ending inventory, one of these methods called "The Gross Profit Method".

The gross profit method is used:

- a) To control and verify the validity of inventory.
- b) To estimate the ending inventory for interim financial reports or internal reports prepared during the year when it is impractical to count the inventory physically and perpetual inventory system is not used.

- c) To estimate the cost of inventory destroyed by an accident, such as fire or storm. Valuation of inventory lost is necessary to account for the accident and to establish basis for insurance claims and income taxes.

To compute the ending inventory by the Gross Profit Method, there are four steps:

1. Compute the total cost of goods available for sale. The cost of goods available for sales consist of Beginning Inventory + Net Purchases + Fright in ; (Net Purchases = Purchases – Discount , Returns & Allowances Purchases)
2. Compute the estimated Gross profit by multiplying Sales ×Gross Profit percentage.
3. Compute the cost of goods sold by subtracting the Computed Gross Profit from Sales.
4. Compute ending inventory by subtracting the computed cost of goods sold from cost of goods available for sale.

To illustrate that, assume the following information:-

Beginning Inventory Br 30,000;

Net Purchases 120,000;

Net Sales 185,000;

Fright in 25,000;

Gross Profit 30% of sales:

Required: Compute ending inventory.

Solution:

Here we are required to follow the four steps listed above:

- 1) Cost of Goods available for sales = $\text{Br}30,000 + 120,000 + 25,000$
= $\text{Br}175,000$
- 2) The estimated Gross Profit = $\text{Br}185,000 * 30\%$
= $\text{Br}55,500$
- 3) Cost of Goods Sold = $\text{Br}185,000 - 55,500$
= $\text{Br}129,500$,or $\text{Br}185,000 * 70\%$
= $\text{Br}129,500$
- 4) Ending Inventory = $\text{Br}175,000 - 129,500$
= $\text{Br } 45,500$

Chapter Two

1. Plant Assets and Intangible Assets

- Plant assets are tangible assets acquired for use in the operation of an enterprise and not intended for resale to customers. These assets are generally long-lived and are expected to provide services to the company for a number of years.
- The properties most frequently included in Plant assets may be described in specific terms as equipment, furniture, tools, machinery, buildings, and land.
- Except for land, plant assets decline in service potential (depreciated) over their economic lives.
- Long-lived assets (plant assets) that are without physical characteristics, are not held for sale, but are useful in the operations of the businesses are classified as *intangible assets*. Some examples of intangible assets are; goodwill, patent, copy right, trade mark and etc.

What differentiates plant assets from other assets?

Here are two important features

i. They are used in operation

- This makes plant asset different from others for instance, inventory that is held for sale and not used in operations. The distinctive feature here is lays on use and not on type of asset.
- E.g. a company that purchases a machine for purpose of reselling it reports it on the balance sheet as inventory. However, if the same company purchases the same machine for use in the operations of the firms it is termed as a plant asset.

ii. Long-lived (have useful lives extending over more than one accounting period)

- This makes plant assets different from current assets such as supplies that are usually consumed in a short time after they are placed in use. The cost of current assets are assigned to a single period when they are used but the costs of plant assets are assigned over the length of their useful lives.

Characteristics of Plant Assets

- They are acquired and held for use rather than for resale.
 - Relatively Long-lived and usually subject to depreciation.
 - Tangible in nature.
 - Does not become included as part of the product.
 - Used frequently to provide goods and services.

Classification of Plant Assets

Generally, plant assets can be classified into *three* main categories:

1. Tangible assets

- This includes assets whose physical characteristics define their utility or usefulness, such as buildings, desks, and equipments.

2. Intangible assets

- This includes assets whose value is not derived from their physicality. For instance, software programs on a CD are intangible assets. The “physical” CD is not the value—the knowledge/programs on the CD really represent the asset.

3. Natural resources

- This includes assets that come from the ground and can ultimately be used up. For example, timber tree, minerals all natural resource assets.

2.2 Cost of Plant Assets

Plant assets are recorded at cost when purchased. This is consistent with the cost principle. Cost includes all normal and reasonable expenditures necessary to get the asset in place and ready for its intended use.

Cost of an asset = Sum of all the costs incurred to bring the asset o its intended purpose

Illustration: Suppose that, M &M enterprise acquired a plot of *land* on January 1, 2006. So, the following are information with regard to the acquisition of the land.

- Br 500,000 is paid for the land, birr 20,000 for real estate commissions
- Br 30,000 is paid for insuring the title
- Br 2,000 is paid for legal fees
- Br 10,000 is paid for surveying, clearing, grading and landscaping
- Br 6,000 was paid for removing the old building
- Br 12,000 is paid for brokers' commissions

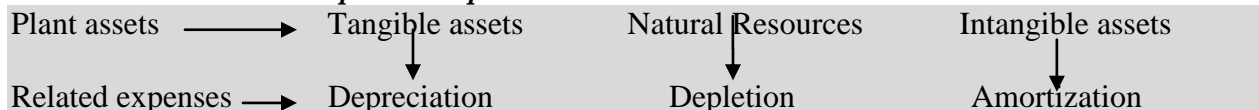
The journal entry needed to record the purchase of land is as follows

Land	580,000
Cash	580,000

2.3 Accounting for Depreciation

- Depreciation is the systematic allocation of the cost of a plant asset to expenses over its estimated useful life. In other words, depreciation is the periodic allocations of cost of plant asset to its economic life.
- Depreciation is an allocation process as opposed to a valuation process.
- Tangible fixed assets, with the exception of land, are subjected to depreciation

Plant assets and their respective expenses



2.4 Measuring Depreciation

Depreciation of a plant asset is based on *three main* factors:

1. Capitalized (original cost)
2. Estimated Useful life (economic life)
3. Estimated Residual value (salvage value)

Capitalized (original cost) cost

- Is a known cost and includes all items spent for the asset to perform its intended function.

Estimated useful (economic) life

- It is the length of the service period expected from the asset.
- Useful life may be expressed in *years, units, or miles*. For each asset, the goal is to define the estimated useful life with the measure (years, units, etc.) that best mimics the asset's decline or use.
E.g., - a building's life can stated in years.

- a truck's can stated in the number of miles it can drive.
- a photo copy machine can stated in the number of copies it can make.

Estimated residual value (salvage value)

- It is the asset's expected cash value at the end of its useful life. A delivery truck's useful life may be 100,000 miles. When the truck has been driven that distance, the company will sell or scrap it.
- It is the expected cash receipt at the end of the truck's economic life.
- Estimated residual value is *not depreciated because you expect to receive this amount at the end*. Cost minus estimated residual value is called *depreciable cost*.
- Depreciable cost equals an asset's total cost minus the asset's expected salvage value.
- The total amount of depreciation expense assigned to an asset never exceeds the asset's depreciable cost.

$$\text{Depreciable Cost} = \text{Original cost} - \text{Salvage Value}$$

- Net book value is an asset's total cost minus the accumulated depreciation assigned to the asset. Net book value rarely equals market value, which is the price someone would pay for the asset. In fact, the market value of an asset, such as a building, may increase while the asset is being depreciated. Net book value simply represents the portion of an asset's cost that has not been allocated to expense.

$$\text{Book Value (BV)} = \text{Original Cost} - \text{Accumulated Depreciation}$$

2.5 Depreciation Methods

Usually, management selects the method or methods it believes to be appropriate in the circumstances for allocating of costs of fixed assets to depreciation expenses.

- The objective is to select the method that *best measures the asset's contribution to revenue over its useful life*. Once a method is chosen, it should be applied consistently over the useful life of the asset. Consistency enhances the comparability of financial statements.
- Depreciation affects the balance sheet through accumulated depreciation and the income statement through depreciation expense.

The most common depreciation methods are:

1. Straight – line method
2. Units of production/activity method
3. Declining – Balance method
4. Sum-of- the- years'- digits method

1. Straight-Line Method

- The straight-line method is the simplest and the most widely used method of determining depreciation.

Under this method:

- ✓ The same amount of depreciation expense is charged each full year the asset is used.
- ✓ Is used for those assets that are subjected to depreciation because of the passage of time.

Formula:

$$\text{Annual Depreciation Expense} = \frac{\text{Acquisition Cost} - \text{Savage value}}{\text{Estimated useful life}}$$

The journal entry to record depreciation expense is as follows.

Depreciation Expense.....xxx
 Accumulated Depreciationxxx

Illustration

Assume that, NANI Company bought a machine for birr 13,000 in January 2007, which is expected to be used for the following 4 years. It is estimated that the machine will have a salvage value of birr 1,000 at the end of its service life. In addition, the machine is expected to produce 40,000 units.

So, the annual Depreciation expense would be:

$$\text{Annual depreciation} = \frac{\text{br}13,000 - \text{br. } 1,000}{4 \text{ years}} = \text{birr } \underline{\underline{3000}}$$

Straight line depreciation frequently is expressed in terms of a percentage rate as follows.

$$\begin{aligned} \text{Depreciation Rate} &= (100\%/n) \times 100, \quad \text{where, } n = \text{useful life} \\ &= (100\%/4 \text{ years}) \times 100 = \underline{\underline{25\%}} \end{aligned}$$

Alternatively, straight line rate can also be computed by dividing annual depreciation to depreciable cost.

$$\text{Straight Line Rate} = \frac{\text{Annual deprecation expense}}{\text{Depreciable cost}}$$

$$\text{Straight Line Rate} = \frac{\text{birr } 3,000}{\text{br. } 12,000 (13,000 - 1000)} = \underline{\underline{25\%}}$$

To record depreciation expense of each year

Depreciation Expense	3,000
Accumulated Depreciation	3,000

Then again, to illustrate more see the depreciation schedule for NANI Company’s machine in the above example can be presented as follows.

**NANI Company
Depreciation Schedule (Straight line Method)**

Year	Depreciable cost	Dep. Rate	Ann.dep.exp.	Accu. Dep	BV
2007	12,000	25%	3,000	3,000	10,000
2008	12,000	25%	3,000	6,000	7,000
2009	12,000	25%	3,000	9,000	4,000
2010	12,000	25%	3,000	12,000	1,000

Exercise: Moon light enterprise bought equipment for birr 95,000 on January 1, 2011. The equipment is estimated to be used for 10 years and it will have a salvage value of birr 5,000 upon its useful life.

Required:

- a. Calculate and journalize the first three years depreciation expense using *the straight line rate* method.
- b. Determine the book value of the equipment at the end of 4th year?

2. Units of production/activity Method

- Under this method, instead of expressing the life as a time period, useful life is expressed in terms of the total units of production or use expected from the asset.
- This method is ideally suited to factory machinery –production can be measured in terms of units of output or in terms of machine hours used in operating the machinery.

- It is also possible to use this method for such items as delivery equipment (miles driven) and airplanes (hours in use).
- This method is generally not suitable for such assets as buildings or furniture, because depreciation for these assets is more a function of time than of use.

Steps to determine depreciation expense

- Calculate depreciation per unit: (Cost-Scrap value) divided by total units produced or hours used.
 - Multiply depreciation per unit/hour by the number of units produced during the period.
- Extending the same example used above for *NANI* Company, the *depreciation expense* through units of production/activity method can be computed as follows.

$$\begin{aligned} \text{Depreciation rate/unit produced} &= \frac{\text{Acquisition cost} - \text{Residual value}}{\text{Total estimated unit produced}} \\ &= \text{birr } \frac{13,000 - 1,000}{40,000 \text{ units}} \\ &= \text{br. } \underline{0.30/\text{unit}} \end{aligned}$$

Supposing that, *NANI* Company’s machine in the example above produced the following units each year:

2007	9,000
2008	11,000
2009	8,000
2010	12,000

The depreciation expenses of each year will be computed in the following depreciation schedule.

NANI Company					
Depreciation Schedule (Units of activity Method)					
<u>Periods</u>	<u>Number of units</u>	<u>Depreciation Per unit</u>	<u>Depreciation Expense</u>	<u>Accumulated Depreciation</u>	<u>Book Value</u>
2007	9,000	0.3	Br 2,700	Br 2,700	Br 10,300
2008	10,000	0.3	3,000	5,700	7,300
2009	9,000	0.3	2,700	8,400	4600
2010	12,000	0.3	3,600	12,000	1,000

Note: When the amount of usage of the plant asset *changes from year to year*, the *unit of activity or production method* is more logical than the straight line method. It may yield fairer allocation of cost again periodic revenue.

3. Declining Balance Method

This method produces a *decreasing annual depreciation expense* over the useful life of the asset. The *depreciable basis* of the asset is the book value of the fixed asset i.e., *cost less accumulated depreciation*. This method is called an **accelerated method** as it results in more depreciation expense in the early years of a plant asset’s life and less depreciation in the latter years of its life. The depreciation rate remains constant from year to year but, the book value to which the rate is applied declines each year.

Annual depreciation expense is computed by multiplying the book value at the beginning of the year by the declining-balance depreciation rate. Book value for the first year is the cost of the asset, because the balance in accumulated

depreciation at the beginning of the asset's useful life is zero. In subsequent years, book value is the difference between cost and accumulated depreciation at the beginning of the year.

Unlike other depreciation methods, salvage value is ignored in determining the amount to which the declining balance rate is applied. Salvage value, however, does limit the total depreciation that can be taken. Depreciation stops when the asset's book value equals expected salvage value.

Steps needed to compute declining balance depreciation:

- i. Calculate the straight-line rate
- ii. Double the straight-line rate
- iii. Multiply the rate determined in *step 2* by the asset's book value at the beginning of the year.

Under this method the percentage of the asset that would be depreciated each year under straight line depreciation times the *accelerator*. For instance, the declining balance rate for an asset with an estimated life of 5 years would be double the straight line rate of 20%, or 40%. So, to calculate the depreciation expense each year the depreciable basis (*book value at the beginning of the period*) would be multiplied by 40%.

Illustration: ABC Company purchased a machine for birr 8,000. The economic life of the machine is 4 years and scrap value of 800. The depreciation *rate* and depreciation *expense* would be as follows:

$$\begin{aligned}
 \text{Double Declining Rate} &= 2 \times \text{straight line rate} \\
 &= 2 \times (100\% / 4) \\
 &= 2 \times 25\% \\
 &= \underline{50\%}
 \end{aligned}$$

So, this rate (50%) is used in order to compute the annual depreciation expense. Details are shown in the following table using the above illustration of ABC Co.

ABC Company					
Depreciation Schedule (Declining balance Method)					
<u>Year</u>	<u>BV at the Beginning</u>	<u>Depreciation Rate</u>	<u>Depreciation Expense</u>	<u>Accumulated Depreciation</u>	<u>BV at the end of the Year</u>
1	8,000	50%	4,000	4,000	4,000
2	4,000	50%	2,000	6,000	2,000
3	2,000	50%	1,000	7,000	1,000
4	1,000	-----	* 200	7,200	800

Under this method *salvage value is not* considered. However, depreciation stops once the book value equals the salvage value. Computation of birr 500 (1,000 x 50%) is adjusted to *birr 200* in order for *book value to equal salvage value*. Hence, we do not use the rate to determine depreciation expense of the *final year* but, the adjustment to the salvage value (beginning book value of the final year less salvage).

4. Sum-of-Years-Digit method

The sum-of-the-years-digits method yields results like those obtained by use of the declining-balance method. The periodic charge for depreciation declines steadily over the estimated life of the asset because a successively smaller fraction is applied each year to the depreciable cost. *For instance*, equipments and vehicles often provide greater benefits when they are new than when

they approach the end of their useful life and more frequently require repairs. Using sum-of-the-years'-digits depreciation is one way for companies to assign a disproportionate share of depreciation expense to the first years of an asset's useful life.

Depreciable cost is determined by deducting salvage value from original cost and it will be the same for all years of useful life of a plant asset. *A fraction to be used for calculating depreciation expense of a period is computed by dividing the remaining useful life of the asset to a constant denominator. The **denominator** of the fraction, which remains the same, is the sum of the digits representing the year's life.*

Formula:

$$\text{Depreciation expense} = (\text{Cost} - \text{Salvage value}) \times \text{Fraction}$$

$$\text{Fraction} = \frac{\text{Numerator}}{\text{Denominator}}$$

Numerator – the number of year's remains in the useful life at the beginning of the period.

Denominator – the sum of the integers from 1 up to the number of years of useful life.

The denominator can also be determined from the following formula

$$S = N [(N + 1) \div 2] \quad \text{where,}$$

S = Sum of the digits

N = Number of years of the estimated life

Illustration: Assume that, KUKU Company bought a machine for birr 16, 000 in January 2008. The economic life and residual value of the machine was 1,000 and 5 years respectively. So, the annual depreciation expense can be shown as follows.

$$\text{Denominator} = \frac{n(n+1)}{2} = \frac{5(5+1)}{2} = \underline{\underline{15}}$$

KUKU Company
Depreciation Schedule (Sum of –the Years Digit Method)

<u>Year</u>	<u>Depreciable Cost</u>	<u>Fraction</u>	<u>Depreciation Expense</u>	<u>Accumulated Depreciation</u>	<u>Book Value</u>
2008	Br 15,000	5/15	Br 5,000	Br 5,000	Br 11,000
2009	15,000	4/15	4,000	9,000	7,000
2010	15,000	3/15	3,000	12,000	4,000
2011	15,000	2/15	2,000	14,000	2,000
2012	15,000	1/15	1,000	15,000	1,000

Journal Entries for the first two years can be shown as below.

2008	Depreciation expense	-----5,000	
	Accumulated Depreciation (Machine)	-----5,000	
2009	Depreciation expense	----- 4,000	
	Accumulated Depreciation (Machine)	-----4,000	

Exercise

1. Assume that, on January 1, 2013 Gibe Band acquired sound equipment for concert performances at a cost of birr 61,000. The band estimated they would use this equipment for 4 years, during which time they anticipated performing about 100 concerts. They estimated at that point they could sell the equipment for birr 1,000. During 2013 the band performed 40 concerts.

Required

Determine the depreciation expense for 2013 using:

- a. Straight line method, and
 - b. The unit-of production method.
2. Omo Company purchased a new machine on October 1, 2012, at a cost of birr 96, 000. The company estimated that the machine will have a salvage value of birr 12, 000. The machine is expected to be used for 84,000 working hours during its 6-year life

2.6 Disposal of plant Assets

A plant asset rarely lasted exactly as long as its estimated life. If it lasts longer than its estimated life, it is not depreciated past the point at which its carrying value equals its residual value. The purpose of depreciation is to spread the depreciable cost of the asset over the economic life of the asset. Thus, the total accumulated depreciation should never exceed the total depreciable cost. If the asset is still used in the business beyond the end of its estimated life, its cost and accumulated depreciation remains in the ledger account. Proper records will thus be available for maintaining control over plant assets. If the residual value is zero, the book value of a fully depreciated asset is zero until the asset is disposed of. In this case, if such an asset is discarded, no gain or loss results.

A plant asset can be disposed by:

1. Discarding it as worthless;
2. Selling it;
3. Trading it in on a new asset;

2.7 Intangible Asset

- Intangible assets represent rights, privileges, and competitive advantages owned by a business.
- They are intangible only in the sense that they *have no physical substance*.

Examples of intangible assets

Patents - Patents right to manufacture, sell, control an invention; granted federal government patent office.

Copyrights - Right to reproduce, sell, an artistic or published work.

Franchises - Right to carry on an enterprise in geographical area or in public property.

Trademarks – Word, phrase, jingle protected federal government patent office.

Goodwill – Arise when an entire business is purchased. Its legal life is not assigned

- Accounting for intangible assets parallels the accounting for plant assets.
- That is, intangible assets are received at cost, and this is expensed over the useful life of the intangible assets in a rational and systematic manner.
- At disposal, the book value of the intangible asset is eliminated, and a gain or loss, if any, is recorded.

Illustration

1. Computation of patent amortization expense

Assume that, ABC Company purchases a patent at a cost of Br 100,000. If the useful life of the patent is 10 years, the annual amortization expense would be:

$$\text{Br}100,000 \div 10 \text{ years} = \underline{10,000}$$

The entry to record the annual amortization patent is:

Patent amortization expense.....	10,000
Patents.....	10,000

2. Computation of Copyright Cost and its Amortization Expense

Assume that, Shalla Music Shop purchased a copyright of popular and ever fashioned music of Nunu for Br 160,000. The music was estimated to sell for the next 40 years. The annual amortization expense for the copyright would be:

$$\text{Br } 160,000 \div 40 \text{ years} = \underline{4,000}$$

Journal entries

Copyright amortization expense	4,000
Copy right.....	4,000

2.8 Accounting for Natural Resources

- Natural Resources are considered "*wasting*" assets, such as timberlands, mineral deposits, etc., that involve extraction of a resource.
- The basic problem is to account for the units taken out of the resource.
- The computation of depletion expense is similar to computing units-of-activity depreciation.

Depletion Expenses

- Depletion is a concept that is identical to depreciation, that is, the allocation of the cost of the Natural Resource to the periods in which it is productive.
- In order to calculate Depletion, one must know the cost of the Natural Resource, as well as the expected volume of the resource that exists.
- The units-of-activity method is generally used to compute depletion, because periodic depletion generally is a function of the units extracted during the year.
- As with the units-of-activity method, the total cost of the natural resources minus salvage value, if any, is divided by the number of units estimated to be in the resource. The result is a depletion cost per unit of product.
- The depletion cost per unit is then multiplied by the number of units extracted and sold, to compute the depletion expense.
- Similar to Equipment or other kinds of plant assets, each Natural Resource account would have its own Accumulated Depletion account.
- When a given natural resource deplete, it is recorded by debiting depletion expense and crediting accumulated depilation account.

Depletion Expense	xxx
Accumulated Depletion.....	xxx

Illustration: Assume that, the KG Oil Company invests birr 20 million in a mine estimated to have 30 million barrels of crude oil and no salvage value. In the first year, 2,000,000 barrels of crude oil are extracted and sold.

So, depletion expense can be computed as follows:

$$\begin{aligned} \text{Depletion cost per barrel} &= \text{Br } 20,000,000 \div 30,000,000 \text{ barrel} = \text{Br } \underline{0.67} \\ \text{Depletion expense} &= \text{Br } 0.67 \times 2,000,000 = \text{Br } \underline{1,340,000} \end{aligned}$$

The journal entry would be as follows.

Depletion Expense1,340,000
Accumulated Depletion.....1,340,000

(To record depletion expense on crude oil deposit)

- Accumulated Depletion, a contra asset account similar to accumulated depreciation, is deducted from the cost of the natural resource in the balance sheet as follows:

Crude oil mineBr 20, 000,000
Less: Accumulated Depletion1,340,000
Br 18, 660,000

Chapter Three

3. Accounting systems for payroll and payroll taxes

All employees of an organization expect and are entitled to receive their remuneration at regular intervals following the close of each payroll period. Regardless of the number of employees and the difficulties in computing the amounts to be paid, the payroll system must be designed to process the necessary data quickly and assure payment of the correct amount to each employee. The system must also provide adequate safeguards against unauthorized payments to employees and other misappropriations of funds.

Various federal, state, and local laws require employers to keep accurate payroll records and to prepare reports and submit to the appropriate governmental units. The law also requires employer's to remit the amounts withheld from its employees and for taxes imposed on itself. These records must be kept for specified periods of time and be available for inspection by those responsible for enforcement of the laws. Besides, payroll data may be useful in negotiations with labor unions, in settling employee grievances, and in determining rights to vacations, sick leaves, and retirement pensions.

Here, in this chapter, you are going to learn intensely and worked through the major concepts that are common to most payroll systems such as the employee's earnings record, payroll sheet (or register), and journal entries related to payroll. Each of these concepts is illustrated and discussed by taking into account the current tax law of the country.

3.1 Importance of payroll accounting

Accounting for payroll is particularly important because:

1. Payroll often represents the largest expense that a company incurs.
2. Both federal and state governments require that detailed payroll records be kept, and
3. Employees are sensitive to payroll errors or irregularities.
4. To maintain good employee morale payroll must be paid on a timely and accurate basis.

3.2 Definition of payroll related terms

1. Salary and Wages

Salary and wages are usually used interchangeably. However, the term wages is more correctly used to refer to payments to unskilled-manual labor. It is usually paid based on the number of hours worked or the number of units produced. Therefore, wages are usually paid when a particular piece of work is completed or weekly. On the other hand, salaries refers to payments to employees who render managerial, administrative or similar services, and they are usually paid to skilled labor on a monthly or yearly basis. Both wages and salaries related to an 'employee' is an individual who works primarily to one organization and whose activities are under the direct supervision of employer. A self-employed person on the other hand works (gives her services) on a fee basis to various firms.

2. **The pay period:** A pay period refers to the length of time covered by each payroll payment.
3. **The pay day:** The pay day- is the day on which wages or salaries are paid to employees. This is usually on the last day of the pay period.
4. **Pay Check:** A business can pay payroll by writing a check for the amount of the net pay. A check is prepared in the name of each employee and handed to employees. Alternatively a check for the total net pay can be prepared for employees to be paid by cash at the organization.

5. Gross Earnings: Gross earnings are the sum of basic salary, over time, and allowance, and bonuses?

7. Payroll Deductions: are deductions from the gross earnings of an employee such as employment income taxes (withholding taxes), labor union dues, fines, credit association pays etc.

6. Net Pay: Net Pay is the earning of an employee after all deductions have been deducted. This is the take home pay amount collected by an employee on the payday.

3.3 Possible components of a Payroll Register

1. Employee Number: Number assigned to employees for identification purpose when a relatively large number of employees are involved in a payroll register.

2. Name of Employees

3. Earnings - Money earned by an employee from various sources. This may include:

a. Basic Salary - a flat monthly salary of an employee for carrying out the normal work of employment and subject to change when the employee is promoted.

b. Allowances - money paid monthly to an employee for special reasons, like:

Position allowance - a monthly paid to an employee of earning a particular office responsibility.

Housing allowance - a monthly allowance given to cover housing costs of the individual employee when the employment contract requires the employer to provide housing but the employer fails to do so.

Hardship allowance - a sum of money given to an employee to compensate for an inconvenient circumstance caused by the employer. For instance, unexpected transfer to a different and distant work area or location.

Desert allowance - a monthly allowance given to an employee because of assignment to a relatively hot region.

Transportation (fuel) allowance - a monthly allowance to an employee to cover cost of transportation up to her workplace if the employer has committed itself to provide transportation service.

c. Overtime Earning: Overtime work is the work performed by an employee beyond the regular working hours. Overtime earnings are the amount paid to an employee for overtime work performed.

Article 33 of proclamation No. 64/1975 discussed the following about how overtime work should be paid:

a. A worker shall be entitled to be paid at a rate of one and one-quarter (1 ¼) times his ordinary hourly rate for overtime work performed before 10:00 P.M in the evening.

b. One and one half (1 ½) times his ordinary hourly rate for overtime work performed between 10:00 P.M and six (6:00 A.M) in the morning.

c. Two (2) times the ordinary hourly rate for overtime work performed on weekly rest days

d. Two and one half (2 ½) times the ordinary hourly rate for overtime work performed on a public holiday.

4. Deduction: are subtractions made from the earnings of employees required by the government or permitted by the employee himself.

a. Employment Income Tax: Every citizen is required to pay employee tax to the government in almost all countries.

According to the revised proclamation **No. 979/2016, in Ethiopia**, employment income is subjected to tax according to the following table.

Employment Income (per month)		Income Tax rate
Over Birr	To Birr	
0	600	Free from Tax
601	1650	10%
1651	3200	15%
3201	5250	20%
5251	7800	25%
7801	10,900	30%
Over 10,900		35%

Taxable income includes any payment or gains in cash or in kind received from employment by an individual, including income from former employment or otherwise or from prospective employment.

Short cut to Income Tax Calculation

Employment Income (per month)		Income Tax rate	Deductions From
Over Birr	To Birr		
0	600	Free from Tax	-
601	1,650	10%	60
1,651	3,200	15%	142.5
3,201	5,250	20%	302.5
5,251	7,800	25%	565.00
7,801	10,900	30%	955.00
Over 10,900		35%	1,500

Income tax= [EI * Rates] – Deductions

b. Pension Contribution

Permanent employees a governmental organization in Ethiopia is expected to pay or contribute 7% (the current pension contribution rate) of their basic salary to the governments' pension trust fund. This amount is withheld by the employer from each employee on every payroll and later be paid to the respective government body.

The employer is also expected to contribute towards this same fund 11% of the basic salary of every permanent government employee. Therefore, the total contribution to the pension fund of the Ethiopian government is equal to 18% of the basic salary of all of its permanent employees. That is, 7% comes from the employees and 9% comes from the employer. This enables a permanent employee of a government organization to be entitled to the pension pay when retiring provided the employee satisfies the minimum requirements to enjoy the benefits.

Business and non-governmental not-for profit organization (NGO's) also have this kind of a scheme to benefit their employees with some modifications. A fund known as provident fund is established and both the employer and the employee contribute towards this fund monthly. When an employee retains or leaves employment, a lump sum amount is paid to him/her

c. Other Deductions: Apart from the above two kinds of deductions, employees may individually authorize additional deductions such as deductions to pay life insurance premiums, to repay loan from the employer, to pay for donation to charitable organization, contributions to "ldir" etc.

5. Net Pay: Net pay represents the excess of gross earnings over total deductions of an employee.

6. Signature: The payroll sheet should have a column for signature of the employee to be taken when the employee collects the net pay.

Illustration of a Payroll Registers

Godanaye is a government agency recently organized to rehabilitate street children. It has five employees whose salaries are paid according to the Ethiopian calendar month. The following data relates to the month of June., 2020.

Serial No.	Name of Employee	Basic Salary	Transp. Allowance	Overtime worked(hr)	Duration of OT Work
01	Aregash Shewa	Br. 730	200	4	6:00-10:00 P.M
02	Paulos Chala	1020	—	8	on rest day
03	Mohammed J.	5300	—	—	—
04	Tensay Belay	1470	—	—	—
05	Haile Olango	950	—	6	Public Holiday

Additional Information

- The management of the agency usually expects a worker to work 40 hours in a week and during Yekatit there are four weeks.
- There were no absentees during the month
- All employees are permanent except Tenssay and Haile
- Paulos agreed to contribute monthly Br. 300 from his salary as a monthly saving in the credit association of the agency.

Required

1. Prepare a payroll register (sheet) for the agency for the month of June, 2020.
2. Record the payment of salary as of June 30, 2020 using check stub No. 0123.
3. Record the payment of the claim of the credit Association of their agency on July. 1, 2020 use check stub No. 0124.
4. Record the payment of the withholding taxes and pension contribution to the concerned government body on July 7, 2020
5. Compute and recognize the total payroll tax expense for the month of June, 2020.

Computation of Earnings, Deductions and Net Pay

Overtime Earning

Overtime earning = OT hrs worked (ordinary hourly rate x relevant OT rate)

1. AREGASH

OT Earning = 4 hours (br. 730 /160 hrs x 1.25) = **br. 22.81**

N.B: Every employee is expected to work 160 hours per month (i.e. 40 hours x 4 weeks)

2. PAULOS

OT Earning = 8 hrs (br. 1020/160 hrs x 2) = br. 102.00

3. HAILE

OT Earnings = 6 hrs (br. 950/160 hrs x 2.5) = br. 89.06

Gross earnings

Gross Earnings = Basic salary + Allowance + OT Earnings

AGEGASH

Gross Earnings = br. 730 + br. 200 + br. 22.81 = br. 952.81

Remember, taxable income in this case is br. 752.81 because; the transportation allowance of br. 200 is not subject to taxation.

PAULOS

Gross Earning = br. 1020 + br. 102 = br. 1122

The Gross Total Earnings of Paulos consists of the br. 1,020 basic salary plus the overtime earnings of br. 102, which is br. 1122.

MOHAMMED

Gross Total Earnings = br. 5,300 which include the basic salary alone

TENSAY

Gross Total Earnings = br. 1470, which is; the basic salary.

HAILE

Gross Total Earnings = br. 950 + 89.06 = br. 1039.06

Deductions and Net Pay

Deductions:

AREGASH:

Income tax:

Gross Total Earnings = br. 952.81

Gross Taxable Income (br. 952.81 – br. 200) = **Br. 752.81**

Income tax = (Taxable Income x 10%) – br. 60

= (br. 752.81 x 0.10) – br. 60 = br. 15.28

Pension contribution

Pension contribution = Basic salary x 7% = Br. 730 x 0.07 = Br. 51.10

Total Deduction (br. 15.28 + br. 51.10) = Br. 66.38

PAULOS:

Income tax:

Gross Total Earning = br. 1,122

Income tax = (Taxable Income x 10%) – br. 60

= (br. 1,122 x 0.10) – br. 60 = **br. 52.20**

Pension Contribution:

Pension Contribution= (br. 1,020 x 0.07) = **br. 71.40**

Total deductions:

Employee Income tax = br. 52.20

Pension Contribution (br. 1020 x 0.07) = br. 71.40

Credit Association = br. 300.00

Total = br. 423.60

MOHAMMED:

Income tax:

Gross Total Earnings = br. 5,300.00
 Income tax = (Taxable Income x 25%) – br. 565.00
 = Br. [5,300.00 x 0.25] -565 = **br. 760.00**

Total Deduction
 Employee Income tax = br. 760.00
 Pension Contribution (br. 5300x 0.07) = br. 371.00
 Total = br. 1,131.00

TENSAY:

Gross Total Earnings = br. 1470.00
 Gross Taxable Income = 1470.00
 Income Tax = (Taxable Income x 10%) – br. 60.00
 = [1,470.00 x 0.10] –br. 60 = **br. 87.00**

NB: Here, there is no pension contribution because; Tensay is not permanent employee of the organization. Therefore, total deduction equals employee income tax i.e., br. 87.00.

HAILE:

Gross Total Earnings = br. 1039.06
 Income Tax = (Taxable Income x 10%) – br. 60.00
 = [1,039.06 x 0.10] – 60 = **br. 43.90**

Pension contribution should not be computed for Haile because he is not permanent employee of the agency. Thus, the only deduction from Haile’s earnings is the employee income tax (i.e., br. 43.90).

Net pay:

Net pay = Gross Total Earnings – Total Deductions
 AREGASH: Net pay = br. 952.81 – br. 66.38) = **br. 886.43**
 PAULOS: Net pay = br. 1,122 – br. 423.60 = **br. 698.40**
 MOH AMMED: Net pay = br. 5,300 – br. 1,131.00 = **br. 4,169.00**
 TENSAY: Net pay = br. 1,470 – br. 87.00 = **br. 1,383.00**
 HAILE: Net pay = br. 1,039.06 – br. 43.90 = **br. 995.16**

1. To prepare a payroll register (sheet) for the agency for the month of June, 2020.

**Godanaye Agency
 Payroll Register (Sheet)
 For the month of June, 2020**

S.N	Name of employee	Earnings			Gross Earnings	Deductions			Total deduction	Net pay
		Basic salary	Allowance	OT		Income tax	Pension contrib.	Others		
01	Aregash Sh.	730	-	22.81	752.81	15.28	51.10	-	66.38	886.43
02	Paulos Cha.	1,020	-	102.00	1,122.00	52.20	71.40	300.00	423.60	698.40
03	Mohamed J.	5,300	-	-	5,300.00	760.00	371.00	-	1,131.00	4,169.00
04	Tensay Belay	1,470	-	-	1,470.00	87.00	-	-	87.00	1,383.00
05	Haile Olango	950	-	89.06	1,039.06	43.90	-	-	43.90	995.16
Total		<u>9,470</u>	<u>-----</u>	<u>213.87</u>	<u>9,883.87</u>	<u>958.38</u>	<u>493.50</u>	<u>300</u>	<u>1,751.88</u>	<u>8,131.99</u>

Prepared by: _____ Checked by _____ Approved by _____

Proving the payroll

Total Earnings:

Basic salary-----	br. 9470.00
Allowances-----	200.00
Overtime-----	<u>213.87</u>
Grand Total-----	<u>br. 9,883.87</u>

Deductions:

Employee Income Taxes-----	br. 958.38
Pension Contributions-----	493.50
Other Deductions-----	<u>300.00</u>
Total Deductions-----	br. 1,751.88
Net Pay Total-----	br. 8,131.99
Total Deductions plus Net pay-----	<u>br. 9883.87</u>

2. To record the payment of salary as of June 30, 2020 using check stub No. 0123.

Salary Expense	9,883.87
Income tax payable	1,662.86
Pension payable.....	493.50
Credit Association payable.....	300.00
Cash.....	7,427.51

(CK. No. 0123)

3. To record the payment of the claim of the credit Association of their agency on July 1, 2020 use check stub No. 0124.

Credit association payable	300.00
Cash.....	300.00

(CK. No. 0124)

4. To record the payment of the withholding taxes and pension contribution to the concerned government body on July 7, 2020.

Payroll tax expense	775.50*
Pension payable.....	775.50

*[775.50= 11% (730 + 1,020+ 5,300)]

i.e., 11% contribution made by the employer to the trust fund for each employee.

5. To compute and recognize the total payroll tax expense for the month of June, 2020.

Pension payable	1128*
Cash	1128

* 1269.00 = (493.50 + 775.50) i.e., total payroll expenses

*493.50 –contributed from the employees

*775.50 –contributed from the employer on the behalf of each employee

CHAPTER FOUR

4. ACCOUNTING FOR PARTNERSHIP

A partnership is an association of two or more persons to carry on as co-owners a business for profit. “The partnership form of business organization is widely used for comparatively small businesses that wish to take advantage of the combined capital, managerial talent, and experience of two or more persons. In addition, a group of physicians, attorneys, or certified public accountants who wish to band together to practice a profession often organized as a partnership. Like sole proprietorships, partnerships are accounting entity or business entity.

4.1 Basic characteristics of partnership

The essential characteristics of a partnership can be identified as follows:-

Limited Life: A partnership may be ended by changes in the composition in the personnel of partners. The former partnership legally ceases and a new one is established as a result of withdrawal of a partner through death, retirement, bankruptcy or incapacity from the partnership and the admission of a new one into the partnership.

Unlimited Liability: Even though a partnership can be either general or limited partnership, there will always be a partner or some partners who will be personally responsible for debts of the firm and have the authority to act for the firm. Statutes for a limited partnership thus require at least one of the partners be a general partner.

Co-ownership of partnership property: Whatever assets once individual partners invest or contribute to a partnership, they retain no specific ownership or claim to these specific assets, they only acquire equity ownership in the total assets of the partnership and thus have claim only on equity ownership interest.

Ownership of partnership Earnings: The earnings of the partnership belong to the partners. Each partner has an ownership interest in earnings, and thus has the right to participate in profits and losses of the partnership. Participation in profits and losses is considered as one of the evidences for the existence of a partnership. This is notwithstanding the way ownership interest and interest in earnings is computed.

Mutual Agency: Except for acts which may be considered above and beyond normal scope of business operations each partner has the authority to act on behalf of the organization and enter into contracts that are binding upon it.

Partnership is a nontaxable entity: Like a sole proprietorship a partnership organization is nontaxable entity. This means that partnership is therefore not required to pay business income taxes on their distributive share of partnership income report. But, the partners must pay their personal income tax.

Partnership agreement (Articles of partnership): A partnership is created by a voluntary contract containing all the elements essential to any other enforceable contract or valid contract. The partnership contract should be in writing & should clearly express the intentions of the partners. Besides, it should contain provisions regarding such matters as the amount of investment to be made, limitations on withdrawals of funds, the activities to be carried on, the manner in which net income or net loss are to be divided, the admission and withdrawal of partners, etc.

4.2 Advantages and Disadvantages of Partnership

The Partnership form of business organization is less widely used than sole proprietorship and corporations. The advantages of the partnership form may outweigh the disadvantages for a particular business endeavor. Here are some of the advantages & disadvantages of partnership.

Advantages of partnership

- ❖ Relatively easy & inexpensive to start and organize it relative to corporation.
- ❖ Opportunity to bring together more capital, more managerial skills, & more experience than would sole proprietorship.
- ❖ Being nontaxable entity/ free from business income tax, etc.

Disadvantages of partnership

- ❖ It has limited life relative to corporation.
- ❖ Each partner has unlimited liability (for general partnership).
- ❖ One partner can bind the partnership (other partners) to contracts.
- ❖ Raising large amounts of capital is more difficult relative to corporation
- ❖ Disagreement among partners may occur (management conflicts) etc.

4.3 Equity reporting for partnerships

Accounting for a partnership is not different from the accounting for a single proprietorship, except for transactions that affect the partners' equities. Upon formation of a partnership form of business organizations, a separate capital account is maintained for each partner in a partnership. Throughout the life of the partnership, as long as the partner remains as co-owner,

the capital account of each partner is affected separately. Each partner's capital account is credited for the value of their investment upon formation of the partnership. Since ownership rights in a partnership are divided between two or more partners, there must be:

- A capital account for each partner
- A drawing account for each partner
- A careful measurement and division of earnings, and
- Care in accounting for admission of new partner and withdrawal of an existing partner.

When partnership is formed, partners may contribute assets in different forms. These assets are valued at their *current fair values* instead of their book values available in the records of the entities before contributions. Moreover, liabilities may also be transferred to the partnership.

Example: On January, 1, 2017, *Ato Chala* and *Ato Degu* decided to form a partnership business, which would provide accounting services. They have been in business separately before they form the partnership. The partnership assumed the liabilities of their separate business. The assets were valued and recorded at their current fair market value. Shown below are the assets contributed and the liabilities assumed by the partnership at their fair market value.

<i>Ato Chala</i>		<i>Ato Degu</i>	
Cash	Birr 6,500	Cash	Birr 3,300
A/Receivable	8,600	A/Receivable	4,300
Supplies	21,000	Supplies	12,000
Equipment	3,000	Building	150,000
A/Payable	(2,300)	A/Payable	(3,200)

The journal entry on January 1, 2017 to record the investment of each partner is as follows:

Cash	6,500		
Account Receivable	8,600		
Supplies	21,000		
Equipment	3,000		
		Account payable	2,300
		Chala's Capital	36,800

Cash	3,300	
A/R	4,300	
Supplies	12,000	
Building	150,000	
	Accounts Payable	3,200
	Degu's capital	166,400

Dividing partnership net income and net loss

Net income is a return to a partnership for carrying out business activities (for rendering services, investing capital, etc). Net income is a profit for performing business activities. If each of the two partners is to contribute equal services and amounts of capital, an equal sharing in partnership net income would be equitable. But, if one partner is to contribute a larger portion of capital than the other, provision for unequal capital contributions should be given recognition in the agreement for dividing net income or, if the services of one partner are much more valuable to the partnership than those of the other, provision for unequal services contributions should be given recognition in their agreement (Articles of Partnership).

To illustrate the division of net income or net loss, two possible agreements are to be considered:

1. Division of the net income or net loss among the partners in exact accordance with their *partnership agreement*, which is of the utmost importance (*capital contributed, value of partner's service, etc could be considered*).
2. If the partnership agreement is *silent* on the matter, the law provides that *all partners share equally, regardless* of differences in amounts of capital contributed, specific skills processed, or time devoted to the business.

Note: The partners may, however, make any agreement they wish in regard to the division of net income & net loss.

Given:

Mr. Roba contributed capital= birr 80,000

Mr Dano contributed capital = birr 120,000

Net income reported during a particular Year= birr 40,000

1. Income division based on capital contributed

Solution:

Share of Mr. Roba: $80,000/200,000 \times \text{birr } 40,000 = \text{Br. } 16,000$

Share of Mr. Dano: $120,000/200,000 \times \text{Br. } 40,000 = \text{Br. } 24,000$

2. When partners are silent(shared equally)

Share of Mr. Roba = Br. 20,000

Share of Mr. Dano = Br. 20,000

4.4 Statements for Partnerships equity

Reporting changes in partnership capital accounts is similar to that for a proprietorship. The primary difference is that there is a capital account for each partner. The changes in partner capital accounts for a period of time are reported in a statement of partnership equity.

Details of the division of net income should be disclosed in the financial statements prepared at the end of the fiscal period, by adding a section to income statement Therefore, details of the changes in the owner's equity of a partnership during the period should also be presented in the statement of owner's equity as in the following form.

R&D Enterprise			
Statement of partnership Equity			
For year ended Dec. 31, 2017			
	<u>Roba</u>	<u>Dano</u>	<u>Total</u>
Capital, January 1, 2017	Br. 80,000	120,000	200,000
Add: Additional investment	-	5,000	5,000
Net income during the year	16,000	24,000	40,000
Less: withdrawals during the year	<u>(1,000)</u>	<u>(2,000)</u>	<u>(3,000)</u>
Capital, Dec. 31, 2017	<u>Br.95,000</u>	<u>Br.147,000</u>	<u>Br. 242,000</u>

4.5 Partnership Dissolution

- Any change in the personnel or partner of the ownership of a partnership results in the dissolution of the partnership.

Reasons for dissolution:

- ❖ admission of a new partner,
- ❖ death of a partner,
- ❖ withdrawal of a partner, or
- ❖ bankruptcy of a partner

Dissolution of the partnership is not necessarily followed by the winding up of the affairs of the business. Thus, in all the above mentioned cases, a new partnership is formed and new articles of partnership should be prepared and the remaining partners may continue to operate the business.

Admission of a New Partner

An additional person may be admitted to a partnership enterprise only with the consent of all the current partners.

An additional person may be admitted to a partnership through either of two procedures:

1. Purchase of an interest from one or more of the current partners
2. Contribution of assets to the partnership

1. **Admission by purchase of an interest:** - when this procedure is followed, the capital interest of the incoming partner is detached from current partners, and neither the total assets nor the total owner’s equity of the business is affected. Under this procedure, the purchase price is directly paid to the selling partner (s) and the only entry needed is the transfer of the proper amounts of owner’s equity from the capital accounts of the selling partner to the capital of the buying partner. The payment of cash is not recorded in the partnership’s records/accounts because the exchange of cash is not a partnership transaction.

Example

Assume that, Mr. Jote and Mr. Solan have capital balances of Br. 50,000 each and on January 21 each sells 1/5 of his respective equity to Mr. Olani , for Be. 10,000 in cash.

The entry required in the partnership accounts is as follows:

January 21	Jote’s, capital.....	10,000
	Solan’s, capital.....	10,000
	Olani’s, capital.....	20,000

Division of net income or net loss among the three partners will be in accordance with the new partnership agreement, not necessarily in accordance with 1/5 interest purchased.

2. **Admission by contribution of assets:** - Instead of buying an interest from the current partners, the incoming partner may contribute assets the partnership. Therefore, both the total assets & the total owner’s equity of the business increase.

Example

Suppose that, Ato Buli has invested Birr 30,000 to a particular partnership on August 1.

The entry to record this transaction is:

August 1	Cash.....	30,000
	Buli's, capital.....	30,000

The total assets & owner's equity is increased by Br. 30,000 & net income or net loss is shared based on newly established/written partnership agreement.

Withdrawal or death of partners

a. Withdrawal of partners

When a partner retires or for some other reason wishes to withdraw from the business firm, one or more of the remaining partners may purchase the withdrawing partner's interest & the business may be continued without apparent interruption. In such cases, settlement for the purchase & sale is made b/n the partner as individuals and it is not recorded by the partnership. The only entry required by the partnership is a debit to the withdrawing partner capital account and a credit to the capital account of the partner or partners acquiring the interest.

b. Death of a Partner

When a partner dies, the accounts may be closed as of the date of death, or at the end of a fiscal year depending upon the articles of the partnership and also, the net income for the period should be transferred to the capital accounts of each partner in accordance with the income sharing ratio, and finally the capital account of the deceased partner is debited for its amount and the corresponding liability account is credited for the same amount.

4.6 Liquidation of Partnerships

Liquidation is the winding-up process of a partnership. When a partnership goes out of business, it usually sells the assets, pays the creditors, & distributes the remaining cash or other assets to the partners according to their claims or capital balance. When the ordinary business activities are discontinued as the partnership goes out of business, the accounts should be adjusted and closed according to the customary procedures of the periodic summary.

The only accounts remaining open then will be the various asset, contra asset, liability & owner's equity accounts. The sale of all non-cash assets is called realization, gains or loss on realizations should be divided among partners based on income sharing ratio. As cash is received or realized, creditors' claims (debts) are paid first and the remaining cash is distributed to the partners, based on their ownership equities or capital balance as indicated by their capital accounts.

The steps in the liquidation process are as follows:

Step 1. Sell the partnership assets. This step is called ***realization***.

Step 2. Distribute any gains or losses from realization to the partners based on their income-sharing ratio.

Step 3. Pay the claims of creditors using the cash from step 1 realization.

Step 4. Distribute the remaining cash to the partners based on the balances in their capital accounts.

Illustration:

Assume that, Farley, Green, and Hall decide to liquidate their partnership. On April 9, after discontinuing its operations and closing the accounts, the following summary of the general ledger of a particular partnership enterprise has been presented below:

Cash	\$11,000	
Non cash assets	64,000	
Liabilities		\$9,000
Jean Farley, capital		22,000
Brad Green, capital		22,000
Alice Hall, capital		<u>22,000</u>
Total	<u>\$75,000</u>	<u>\$75,000</u>

Accounting for the liquidation of the partnership by using three different selling prices for the non-cash assets are:

I. Gain on Realization

II. Loss on Realization: No capital deficiencies

III. Loss on Realization: Capital deficiency

I. Gain on Realization

Assume that Farley, Green, and Hall sell all noncash assets for \$72,000. Thus, a gain of \$8,000 (\$72,000- \$64,000) is realized. The partnership is liquidated during April as follows:

Step 1. Sale of assets: \$72,000 is realized from sale of all the noncash assets.

Step 2. Division of gain: The gain of \$8,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2.

Thus, the partner capital accounts are credited as follows:

Farley \$4,000 (\$8,000 x50%)

Green \$2,400 (\$8,000 x30%)

Hall \$1,600 (\$8,000 x20%)

Step 3. Payment of liabilities: Creditors are paid \$9,000.

Step 4. Distribution of cash to partners: The remaining cash of \$74,000 is distributed to the partners according to their capital balances as follows:

Farley \$26,000

Green \$24,400

Hall \$23,600

A statement of partnership liquidation, which summarizes the liquidation process, can be shown below.

Farley, Green, & Hall						
Statement of Partnership Liquidation						
For Period April 10-30, 2018						
	Cash +	Non cash assets	= Liab. +	Capital		
				Farley +	Green+	Hall
				(50%)	(30%)	(20%)
Balance before realization	\$11,000	\$64,000	\$9,000	\$22,000	\$22,000	22,000
<i>Sale of non-cash assets &</i>						
<i>division of gain</i>	<u>+72,000</u>	<u>64,000</u>	-	+ <u>4,000</u>	+ <u>2,400</u>	+ <u>1,600</u>
Balance after realization	\$83,000	0	\$9,000	26,000	24,400	23,600
<i>Payment liabilities</i>	<u>-9,000</u>	<u>-</u>	<u>-9,000</u>	<u>-</u>	<u>-</u>	<u>-</u>
Bal. after pyt of liab.	74,000	0	0	26,000	24,400	23,600
<i>Dist. of cash to partners</i>	<u>-74,000</u>	<u>-</u>	<u>-</u>	<u>-26,000</u>	<u>-24,400</u>	<u>-23,600</u>
Final balances	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

The journal entries to record the liquidation procedures (process) given above are the following

1. Sale of Non-Cash Assets & Realization of Gain

Cash.....	72,000
Non cash assets.....	64,000
Gain on realization.....	8,000

2. Division of Gain to Partners

Gain on realization.....	8,000
Farley, capital.....	4, 000
Green, capital.....	2,400
Hall.....	1,600

3. Payment of Liabilities

Liabilities.....	9,000
Cash.....	9,000

4. Distribution of Cash to Partners

Farley, capital.....	26,000
Green, capital.....	24,400
Hall, capital.....	23,600
Cash.....	74,000

II. Loss on Realization: No Capital Deficiencies

Assume that, in the foregoing illustration the three co-owners dispose or sell all non-cash assets for \$44,000 incurring a loss of \$20,000 (64,000-44,000).

The liquidation of the partnership is as follows:

Step 1. Sale of assets: \$44,000 is realized from the sale of all the noncash assets.

Step 2. Division of loss: The loss of \$20,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2.

Thus, the partner capital accounts are debited as follows:

Farley	\$10,000 (\$20,000 x 50%)
Green	6,000 (\$20,000 x 30%)
Hall	4,000 (\$20,000 x 20%)

Step 3. Payment of liabilities: Creditors are paid \$9,000.

Step 4. Distribution of cash to partners: The remaining cash of \$46,000 is distributed to the partners according to their capital balances as follows:

Farley	\$12,000 (22,000 – 10,000)
Green	16,000 (22,000 – 6,000)
Hall	18,000 (22,000 – 4,000)

These steps can be summarized in the following statement of partnership liquidation

Farley, Green, & Hall
Statement of Partnership Liquidation
For Period April 10 - 30, 2001

	Cash	+ Noncash assets	= Liab. +	Capital		
				Farely +	Greene	+ Hall
				(50%)	(30%)	(20%)
Balance before Realization ...	\$11,000	\$64,000	\$9,000	\$22,000	\$22,000	22,000
<i>Sale of non-cash asset</i>						
<i>& division of loss</i>	<u>+44,000</u>	<u>-64,000</u>	<u>-</u>	<u>-10,000</u>	<u>-6,000</u>	<u>-4,000</u>
Balance after realization	\$55,000	0	\$9,000	\$12,000	\$16,000	18,000
<i>Payment of liabilities</i>						
	<u>- 9,000</u>	<u>-</u>	<u>-9,000</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance after pyt of liab.	46,000	0	0	12,000	16,000	18,000
<i>Dist. of cash to partner</i>						
	<u>-46,000</u>	<u>-</u>	<u>-</u>	<u>-12,000</u>	<u>-16,000</u>	<u>-18,000</u>
Final balances	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>

Here are entries to record the liquidation process outlined above:

1. Sale of Non-Cash Assets & Realization of loss

Cash.....	44,000
Loss on realization.....	20,000
Non cash assets.....	64,000

2. Division of loss to Partners

Farley, capital.....	10,000
Green, capital.....	6,000
Hall, capital.....	4,000
Loss on realization.....	20,000

3. Payment of liabilities

Liabilities.....	9,000
Cash.....	9,000

4. Distribution of cash to partners

Green, capital.....	16,000
Farley, capital.....	12,000
Hall capital.....	18,000
Cash.....	46,000

II. Loss on Realization: Capital deficiency [reading assignment]

CHAPTER FIVE

5. ACCOUNTING FOR CORPORATIONS

A corporation is an artificial person, created by law, and having a distinct existence separate and apart from the natural persons who are responsible for its creation and operation. Thus, corporation is invisible and has no physical existence.

Corporations may be classified as:

1. **Not for profit:** - include those organized for recreational, educational, charitable, or other purposes. For their continuation, they depend upon dues from their members or upon gifts and grants from the public at large. Other for not profit corporations, renders services to the public for a fee (on cost basis).
2. **For profit:** - are engaged in business activities. They depend upon profitable operations for their continued existence. For profit corporations may be public or non public corporation. Corporations whose shares /stocks are owned by a small group of people are called non public corporations and those shares or stocks are traded in a public market are called public corporations. This particular chapter focuses on profit corporations.

5.1 Nature of a Corporation

Most large businesses are organized as corporations. For instance, in US corporations generate more than 90% of the total business dollars. In contrast, most small businesses are organized as proprietorships, partnerships, or limited liability companies.

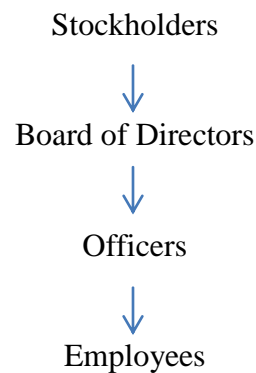
5.2 Characteristics of a Corporation

As a legal entity, the corporation has certain characteristics that make it different from other types of business organization and have accounting implications:

- ✓ A corporation has a separate legal entity and distinct from its owners.
- ✓ A corporation has its own charter or certificate of incorporation which may specify activities to be engaged in, general assembly, audit procedures nature of stock, etc.
- ✓ The existence of a corporation is not affected by changes in ownership.
- ✓ Owners of a corporation are stock holders or share holders.
- ✓ The ownership of a corporation is divided into transferrable units known as shares of stock.
- ✓ The stock holders (owners) of a corporation have limited liability.

- ✓ The stock holders exercise control over the management of corporate affairs indirectly by electing a board of directors.
- ✓ The Board of directors determines the corporate policies and officers
- ✓ A corporation can obtain more capital/fund by issuance of stocks/shares.
- ✓ Variety of ownership interests (common stock and preferred stock)
- ✓ Formality of profit distribution.
- ✓ Subject to state laws (regulations and supervisions).

Organizational structure of a corporation



The stockholders control a corporation by electing a board of directors. This board meets periodically to establish corporate policies. It also selects the chief executive officer (CEO) and other major officers to manage the corporation's day-to-day affairs.

Advantages of Corporation

- ✓ Unlimited life or existence
- ✓ Owners or stockholders have limited liability
- ✓ Professional Management
- ✓ Opportunity to raise/acquire more capital
- ✓ Ease of transfer of ownership interest, etc

Disadvantages of Corporation

- ✓ Double taxation
- ✓ Difficulty of establishment because of various legal requirements
- ✓ Less freedom of action relative to sole proprietorship & Partnership.
- ✓ Subject to laws of state of incorporation etc.

5.3 Stockholders' Equity

The owners' equity in a corporation is commonly called as *stockholders' equity, shareholders' equity, share-holders' investment, or capital.*

The two main sources of stockholders' equity are:-

1. Investments contributed by the stockholders, or paid-in capital, or contributed capital.
2. Net income retained in the business or retained earnings.

The paid-in capital contributed by the stockholders is recorded in separate accounts for each class of stock. If there is only one class of stock, the account is entitled Common Stock or Capital Stock.

A retained earnings is a corporation's cumulative net income that has not been distributed as dividends. Dividends are distributions of a corporation's earnings to stockholders. Sometimes retained earnings that are not distributed as dividends are referred to in the financial statements as earnings retained for use in the business and earnings reinvested in the business.

Net income increases retained earnings, while a net loss and dividends decrease retained earnings.

5.4 Characteristics of Capital Stock

The general term applied to the shares of ownership of a corporation is capital stock. The number of shares that a corporation is authorized to issue is set forth in its charter. The term issued is applied to the shares issued to the stockholders. The shares of capital stock are often assigned an arbitrary monetary figure, known as par. The par amount is printed on the stock certificate, which is the evidence of ownership issued to the stockholder. Stock may also be issued without par or stated value, which are called No-par stocks. Because of the limited liability feature, the creditors of a corporation have no claim against the personal assets of the stockholders. However, the law requires that some specific minimum contribution by the stockholders be retained by the corporation for the protection of its creditors, which is called legal capital usually includes the par value of the shares of capital stock issued.

Capital stock may be issued at par, above par, or below par. Par value is not an indicator of market value. It is a legal matter. When stock is issued above or below par the excess or deficiency is recorded in a premium account called *paid in capital in excess of par.*

The difference b/n authorized, issued, and outstanding shares are summarized as follows.

Authorized shares-----100,000

Issued shares -----30,000

Un-issued shares-----70,000

Assume further, if the corporation has repurchased 1,000 shares to date, the authorized shares, treasury stocks, unissued stocks, and outstanding stocks would be as follows.

Authorized shares-----100,000

Treasury stocks -----(1,000)

Unissued -----(70,000)

Outstanding shares ----- 29,000

The major basic rights that go along with ownership of a share /stock are:

- ✓ The right to vote in matters concerning the corporation.
- ✓ The right to share in distributions of earnings.
- ✓ The right to purchase a proportionate (preemptive right).
- ✓ The right to share in assets upon liquidation.

5.5 Classes of stocks and their characteristics

1. Preferred stocks: - they have some preferential rights or preferences to share on distributions of earnings over other class of stocks.

Preferred stocks have the following preferences privileges

- Preference to dividend
- Preference to asset upon liquidation
- Callable at the option of the corporation
- Convertible to common stock at their option
- Non-voting right

Cumulative and Non-cumulative preferred stock: cumulative preferred stock holders have the right of postponing the preferential dividend right if at any time the directors pass or don't declare the usual dividend due to various reasons. Thus, during the next accounting period, any dividend accrued or in arrears is first paid to cumulative preferred stock holders and followed by the payment of dividend to non cumulative preferred stock holders and finally if there is

remaining dividend it is paid to common stock holders. Therefore, non cumulative preferred stock holders have no right to obtain accrued or accumulated dividend or undeclared or unpaid dividend in the previous accounting period.

2. Common stock: - they control the management of the corporation through *voting right*. They represent the basic ownership interest of the corporation.

Rights of common stocks

- They have voting right
- They participate in or obtain residual net income or dividend and
- They participate in allocation asset upon liquidation
- They participate in additional issues of stocks

5.6 Issuing Capital Stock

The entry to record investments of stock holders in a corporation is cash and other assets received are debited and any liabilities assumed and preferred/common stocks (Stock holders equity) are credited.

Illustration: Assume that, a corporation, with authorization of 10,000 preferred stock of \$100 par & 100,000 common stock of \$20 par, issues ½ of each authorization at par for cash. The entry to record the stock holders’ investment is as follows:

March 10	Cash.....	1500,000
	Preferred stock.....	500,000
	Common stock.....	1,000,000

Premium and Discount on Stock

Capital Stock is often issued by a corporation at a price other than par. When it is issued for more than par, the excess of the contract price over par is termed as a premium on the stock and the paid-in capital in excess of par account is credited for the amount of the premium. However, the paid-in capital is not a part of legal capital & may be used as a basis for dividends to stock holders. When it is issued at a price that is below par, the difference is called *discount on the stock*. Cash or other assets are debited for the amount received, and a discount on capital stock account is debited for the amount of the discount, and the capital stock (common or preferred) account is credited for the par value. Therefore, the discount on capital stock is deducted from the par amount of capital stock in the paid-in capital subsection of stockholder’s equity. However, capital stock is not issued at discount. Up on liquidation, stockholders of discounted

capital stock may be forced to contribute to the extent of the discount if there are no enough assets to pay creditors. The *implication* to this fact is that stockholders are limited liability.

The entry to record premium on capital stock is:

April 21	Cash.....	xxx
	Preferred stock.....	xxx
	Paid-in capital in excess of par-preferred.....	xxx

In general, the price at which stock can be sold by a corporation can be influenced by:

- The financial condition, the earnings record & the dividend record.
- Its potential earning power.
- Availability of money for investment purposes.
- Business & economic conditions

N.B: if a corporation incurs loss during fiscal year, which cannot be covered by the retained earnings; it is called *deficit* and deducted from total paid -in -capital on the balance sheet.

Issuing Stocks for Assets Other than Cash

When capital stock is issued in exchange for assets other than cash such as land, building, equipment, etc, the assets acquired should be recorded at their at the fair market price of the stock issued.

Illustration: Assume that, a corporation acquired land for which the fair market price is not determinable. In exchange, the corporation issued 10,000 shares of its \$10 par common stock with a current market price of \$12 per share.

The transaction could be recorded as follows:

Dec. 5	Land.....	\$120,000
	Common stock.....	100,000
	Paid-in capital in excess of par-common.....	20,000

No – Par Stock

Both preferred and common stocks may be issued without a par term. However, preferred stock is usually assigned a par. When no-par stock is issued, the entire proceeds may be credited to the capital stock account, even though the issuance price varies from time to time.

Illustration

Suppose that, on April 28, ABC Corporation issues 10,000 shares of no-par common stock of \$30 per share & on May 15, issues 1,000 additional similar shares at \$20 per share.

The entries could be recorded as follows:

April 28	Cash.....	\$300,000
	Common stock.....	\$300,000
May 15	Cash.....	\$20,000
	Common stock.....	20,000

N.B: When no-par stocks are assigned a stated value per share, the excess of the proceeds (at market price) over the stated value may be credited to paid-in capital in excess of stated value.

Subscription and Stock Issuance

The stock could also be issued with the arrangements that the subscriber's sign a contract to effect payment for a specified numbers of shares in installment and the share would be issued to the subscribers up on the final payment.

To illustrate, assume that, on Feb. 1, 2005 TG Co. signed a stock subscription agreement to issue 10,000 shares of common stock birr 9 par value for birr 10 per share. A birr 20,000 down payment was collected. The remainder of the subscription price is due in two equal installments on March 1, 2005 and April 1, 2005.

On Feb. 1, 2005, the transaction will be recorded as follows:

Feb. 1	Stock subscription Receivable -----	80,000
	Cash -----	20,000
	Common Stock (10,000 x br 9) -----	90,000
	Paid -in -capital in excess of par -----	10,000

When the first installment is collected on March 1, 2005, the following entry would be made.

March 1,	Cash (80,000 x ½) -----	40,000
	Stock subscription Receivable-----	40,000

On April 1, the final installment and the shares are issued to the subscriber's. On this date the following entry is reported.

April 1	Cash (80,000 x ½) -----	40,000
	Stock subscription Receivable -----	45.7 Treasury Stock

- Treasury stock refers to capital stock that is reacquired by a corporation. It has no voting, dividend, or other stockholder rights.

Main reasons for re-acquisition of stocks

- To have shares available for distribution to employees under bonus plans
- To support (increase) the market price of the stock
- To increase EPS by reducing the number of share outstanding
- To decrease dividend payment by reducing the number of share outstanding
- To use the share acquired for stock dividend To reissue with higher price

If treasury stock is resold, no gain or loss is recognized on the exchange because; the corporation’s primary objective is not to make profit by trading sin its own stock. In addition, the treasury stocks are not the assets; rather they are deductions from the stockholders equity. The recording of the treasury stock is based on the cost of the shares that were purchased.

Assume that, on April 1, 2001 Z Company bought 100,000 shares of its stock in the open market when it selling price was birr 22 per share.

Using cost method, the company records the following journal entry.

April 1	Treasury stock (10,000 x 22) -----	2,200,000
	Cash -----	2,200,000